HOOVER INSTITUTION
IDEAS DEFINING A FREE SOCIETY
HOOVER DAILY REPORT

Monday, June 22, 2015 »

How The U.S. Can Return To 4% Growth

by R. Glenn Hubbard, Kevin M. Warsh
via The Wall Street Journal
Sunday, June 21, 2015

Economic growth in real terms is averaging a meager 2.2% annual rate in the 23 quarters since the recession's trough in June 2009. The consensus forecast of about 1% growth for the first half of this year offers little solace.

Americans need not be resigned to such a dim fate. A clarion call for faster economic growth—even 4%, as presidential candidate Jeb Bush recently said—is a worthy and viable aspiration. The economy has achieved it before: The average growth rate was 4% or higher 17 times in the rolling four-year periods since 1950. It can reach that goal again. But it won't be easy, and it will require a fundamental change in the conduct of economic policy.

History suggests a dramatic surge in economic growth is often preceded by a persistent shortfall in economic performance. After the severe recession of 1973-75, for example, the economy grew at a 3.6% annual real rate during the 23 quarters that followed.

History also makes clear that better macroeconomic policies can drive growth. President Reagan's agenda—tax cuts, regulatory reforms and support of sound monetary policy—are a prominent example. After the deep recession of 1981-82, real GDP growth averaged 4.8% in the next 23 quarters. President Kennedy's personal income-tax rate cuts in the mid-1960s and President Clinton's tax reductions on capital accompanied by budget restraint in the late 1990s offer other examples of pro-growth policy improvements.

So why hasn't the country rebounded sharply in the past six years?

The recession was officially over in mid-2009, and toward the end of that year the economy showed signs of recovery. A massive fiscal spending stimulus had been signed into law. The Federal Reserve was embarking on an unprecedented monetary accommodation. Leading economists and forecasters predicted the economy would respond to this policy elixir with a great surge in performance.

On Dec. 9, 2009, for example, the Federal Reserve staff presented its "Long-Term Outlook" for economic growth to the Federal Open Market Committee. In the so-called Greenbook forecasts, Fed staff projected that real GDP would grow by 3.6% at an annual rate in 2010, increase to 4.5% in 2011, peak at 4.7% in 2012 and 2013, and then grow 3.2% in 2014. These kinds of growth rates were not without precedent, and the Fed's forecasting record compares favorably with the Blue Chip forecasts of private forecasters.

But growth has been about one-half of the Fed's projections. The country has experienced the weakest expansion since World War II. Participation in the labor force is near its lowest level since 1978. The country is in the midst of the worst five-year run for productivity ever measured outside of a recession. All the while, households and businesses with big balance sheets have been enriched by the superior performance of the stock market.

Many leading economic thinkers judge the economy's underperformance as unrelated to the policies adopted in the last several years. Instead, their thinking goes, the economy is no longer capable of performing as in previous recoveries. So Americans should resign themselves to a low-growth trajectory. Some call this the “new normal,” others “secular stagnation.” And some forecasters seem convinced that these pessimistic projections are as reliable as optimistic projections of several years ago.

We strongly disagree. A more vigorous recovery from the financial crisis was an opportunity squandered. Even today, the economy can grow at significantly higher rates than the prevailing pessimism.

The next president can and should raise the country’s hopes and aspirations. But words alone won’t suffice. Instead, what’s needed for more rapid growth is a long-term commitment to policies that significantly increase U.S. economic potential. Short-term policies such as temporary tax and spending changes that have characterized the recent years should be set aside in favor of longer-term tax reform and removal of other barriers to economic growth.

This means policies that bring more people into the workforce. It means encouraging real capital investment to drive higher levels of productivity growth. It means resetting long-run expectations of potential for every individual, household and business. It means making the United States the best place in the world in which to invest and work.

Examples? Fundamental tax reform that is directed at increasing the incentives for work and driving investment in productive assets. Real regulatory reform that firmly and consistently recognizes, measures and balances economic benefits and costs—and no longer protects incumbent firms from disruptive new competitors. Tax and regulatory reform can make the United States the preferred destination for work and investment.

Trade policies must continue to break down non-tariff barriers to open global markets. Education policy must be geared toward empowering schools to put students and the skills they need above entrenched interests. And support for training can foster investment in skills over time.

When the right policy choices are made, monetary policy could get out of the business of trying to bail out the economy from the failings of other macroeconomic policies.

Long-term economic forecasting is difficult, and economic models are not crystal balls. But directional policy changes are essential.

The underperformance of the economy in recent years should cause policy makers to revisit their failed prescriptions for higher economic growth. A fundamentally new set of economic policies should be enacted to give growth a chance. And setting a goal of 4% growth invites meaningful policy contributions from those who would be our leaders.

Mr. Hubbard, dean of Columbia Business School, was chairman of the Council of Economic Advisers under President George W. Bush. Mr. Warsh, a former Federal Reserve governor, is a distinguished visiting fellow at Stanford University's Hoover Institution and a lecturer at the Stanford Graduate School of Business.